



Special Report

The Case for Convertibles

October 10, 2008

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A Tough Year So Far

2008 has been a difficult year for the financial markets as stocks and most bonds have been punished. The convertible securities market has not been spared. **We believe that the recent period of disappointing convertible performance translates into opportunity and that the convertibles market is now attractively valued and poised, once again, to deliver equity-like returns with less risk than common stock.**

Why Convertibles?

Convertibles are hybrid securities -- a combination of debt and equity. Convertibles provide income in the form of coupons or dividends. The current yield of a convertible is typically much higher than the yield of the underlying common stock. Convertibles also offer equity participation by allowing investors to participate in the movement of the common stock into which such securities convert. **The combination of fixed income and equity characteristics results in a security that is expected to offer a superior-risk reward profile.** When the stock appreciates, the convertible participates in the move, though typically to a lesser extent than the common stock move. If the stock declines, the fixed income characteristics of the convertible provide a cushion. The convertible should decline less, and perhaps much less than the underlying common stock. Based on the historical relationship between convertible securities and equities, we seek attractively valued convertibles that offer a total return (bond price change plus coupon or dividend) that equates to about 70% of the appreciation of the underlying common stock and less than 50% of the downside over a one-year holding period.

Table 1 below highlights convertible returns as represented by the Merrill Lynch All US Convertibles Index (a capitalization weighted index of approximately 700 convertible securities that represents the convertible universe) as compared with the returns of the S&P 500 Index (an unmanaged index that is widely recognized as an indicator of general market performance and which does not have a defined investment objective) and includes trailing 20-year and 10-year returns and volatility as of September 30, 2008. **Convertible returns over the 20-year period ended September 30th were approximately 85% of S&P 500 return with lower volatility. For the trailing 10-year period, convertibles returns exceeded the S&P 500 by 65% also with lower volatility.**

Table 1		
Convertible Returns versus Common Stock Period Ending 9/30/08		
Trailing 20-Year Performance		
	Ann'l Total Return	Volatility
Merrill Lynch Convertibles Index	8.48%	11.43%
S&P 500	9.94%	13.83%
Trailing 10-Year Performance		
	Ann'l Total Return	Volatility
Merrill Lynch Convertibles Index	5.05%	13.08%
S&P 500	3.06%	14.31%

Why Have Recent Results Been Disappointing?

Convertibles have been under considerable pressure so far this year, as indicated by the data in Table 2. **The Merrill Lynch All US Convertibles Index underperformed the S&P 500 by more than 900 basis points in the third quarter of 2008** and by 172 basis points through the first nine months of 2008. This performance is unprecedented and represents a very unusual departure from the relative performance of convertibles over the long term (10- and 20-year comparison periods).

The magnitude of the third quarter underperformance of convertibles was so significant that it also diminished the 5-year relationship of returns and volatility as shown below.

	Sept '08	Q3 '08	YTD '08
Merrill Lynch Convertibles Index	-14.59%	-17.56%	-21.01%
S&P 500	-8.91%	-8.37%	-19.29%
Trailing 5-Year Performance			
	Ann'l Total Return		Volatility
Merrill Lynch Convertibles Index	2.28%		10.01%
S&P 500	5.17%		10.26%

There are three principal reasons for the recent poor performance of convertibles. **First, yield spreads have widened.** The spread on high yield bonds widened to 1091 over US Treasuries from about 800 over at the end of 2007. High yield spreads are now approaching the all-time high of 1126 over Treasuries set in October, 2002. In many cases, the spread deterioration was much worse. **The widening of spreads lowered the bond values of convertibles and impaired their defensive characteristics.** Consequently, convertibles fell more than traditional measures would suggest based on the common stock declines. In fact, **many convertibles are actually trading at wider implied credit spreads than “straight” bonds offered by the same company.**

Second, there has been considerable **selling pressure from convertible hedge funds that have received requests for redemption** following many months of negative returns. The selling has often been indiscriminate. Even high quality names have come under pressure as traders sell securities based on where they can find liquidity.

Finally, **the SEC ban on short sales of the stocks of approximately 800 financial companies, which has now been lifted, resulted in unusual pressure on the prices of financial convertibles.** Hedge fund sellers of financials could not find buyers because no one was able to put on new positions (long stock and short the convertible) as they could not short the common stock needed to establish the hedge. The pressure on the convertibles market was **exacerbated by the significant weight of financials (approximately 25%) in the convertibles universe.**

What is the Opportunity?

There are several reasons why convertibles are attractive at this juncture. According to Merrill Lynch Convertibles research, the convertibles universe was theoretically 3% cheap as of the end of the third quarter of 2008 (4½% cheap as of October 9th). Many securities that were indiscriminately sold are an even bigger bargain. **Merrill Lynch reported that convertibles were fairly valued one year ago and arguably are now the cheapest that they have been since 2002.**

Most investors are attracted to the income component of convertible securities. **The recent steep decline in convertibles combined with higher coupons on many newer offerings has resulted in the highest current yield in six years. Convertibles now yield 5.15% compared to 2.93% as of September 30, 2007.** Also, despite the higher current yield, convertibles still offer good participation in the appreciation of the underlying common stock.

Many convertibles are trading at or below their theoretical bond value (i.e., the level where the bonds would trade if they did not have a convertible feature and were valued based on the spread implied by straight bonds issued by companies with similar credit profiles). A high bond value, also known as investment value, relative to the convertible price, implies that the convertible will be more defensive if the underlying stock declines.

Investors are fleeing convertibles at the point of maximum pain. We believe that this is the worst possible time to abandon the market as it represents the point of maximum opportunity. **The convertibles market is cheap and offers good income. The ban on shorting financials stocks has been lifted. That should spur new hedge fund demand for financial convertibles and lift prices.**

Credit spreads are historically wide and likely to narrow even if equities languish at current levels. Many companies with outstanding convertibles have moderate debt loads, good cash positions and cash flow that is more than adequate to fund their obligations. As the credit markets normalize and dislocations in the convertibles market are corrected, investors will see value in convertible securities. Many convertibles that now imply yields greater than non-convertible fixed income securities issued by the same company could be snapped up by savvy investors. Convertibles, through a combination of current income and capital appreciation due to spread compression could perform well, even if stock returns are modest.

The stock market looks to be challenging over the near term. But stocks will eventually recover. **The convertible securities market offers investors an opportunity to participate in equities in a risk-averse manner. Over time, investors should enjoy equity-like returns and lower volatility than typically experienced in stocks.**